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EXECUTIVE SECRETARIAT

Routing Slip

TO:

		ACTION	INFO	DATE	INITIAL
1	DCI				
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3	EXDIR				
4	D/ICS				
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7	DDO				
8	DDS&T				
9	Chm/NIC				
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11	IG				
12	Compt				
13	D/EEO				
14	D/Pers				
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Remarks:

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JRC
Executive Secretary
6/29/83
Date

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Executive Registry
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WASHINGTON

CABINET AFFAIRS STAFFING MEMORANDUM

~~DDI~~

DATE: 6/29/83 NUMBER: 118794CA DUE BY: ____________

SUBJECT: Cabinet Council on Economic Affairs - Thursday, June 30, 1983
8:45 a.m. - Roosevelt Room

	ACTION	FYI
ALL CABINET MEMBERS	☐	☐
Vice President	☑	☐
State	☑	☐
Treasury	☑	☐
Defense	☑	☐
Attorney General	☐	☑
Interior	☐	☑
Agriculture	☑	☐
Commerce	☑	☐
Labor	☑	☐
HHS	☐	☑
HUD	☑	☐
Transportation	☐	☑
Energy	☐	☑
Education	☐	☑
Counsellor	☑	☐
OMB	☑	☐
CIA	☐	☑
UN	☐	☑
USTR	☑	☐
CEA	☑	☐
CEQ	☐	☐
OSTP	☐	☐
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	ACTION	FYI
Baker	☑	☐
Deaver	☐	☐
Clark	☐	☑
Darman *(For WH Staffing)*	☑	☐
Harper	☑	☐
Jenkins	☐	☑
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____________	☐	☐
CCCT/Gunn	☐	☐
CCEA/Porter	☑	☐
CCFA/Boggs	☐	☐
CCHR/Carleson	☐	☐
CCLP/Uhlmann	☐	☐
CCMA/Bledsoe	☐	☐
CCNRE/Boggs	☐	☐

REMARKS:

The Cabinet Council on Economic Affairs will meet on Thursday, June 30, 1983 at 8:45 a.m. in the Roosevelt Room. The agenda and background papers are attached.

RETURN TO:

☐ Craig L. Fuller
Assistant to the President
for Cabinet Affairs
456-2823

☑ Becky Norton Dunlop
Director, Office of
Cabinet Affairs
456-2800

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THE WHITE HOUSE

WASHINGTON

June 28, 1983

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: ROGER B. PORTER RBP

SUBJECT: Agenda and Papers for the June 30 Meeting

The agenda and papers for the June 30 meeting of the Cabinet Council on Economic Affairs are attached. The meeting is scheduled for 8:45 a.m. in the Roosevelt Room.

The first agenda item is a review of differences between the U.S. and European Community agricultural policies. Secretary Block requested that the Cabinet Council consider this issue. A paper from him on "U.S. and E.C. Agricultural Policy Differences" is attached.

The second agenda item is a report from the Working Group on Federal Credit Policy. For several weeks the Working Group has discussed alternative approaches to advancing the Administration's objective of privatizing the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC). The Working Group has also considered at length Trust for Investment in Mortgages (TIMs). Two papers from the Working Group on "FNMA and FHLMC Privatization" and "Trust for Investment in Mortgages" are attached.

Attachments

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THE WHITE HOUSE

WASHINGTON

CABINET COUNCIL ON ECONOMIC AFFAIRS

June 30, 1983

8:45 a.m.

Roosevelt Room

AGENDA

1. U.S. and E.C. Agricultural Policy Differences (CM#293)
2. Report of the Working Group on Federal Credit Policy (CM#113)

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DEPARTMENT OF AGRICULTURE
OFFICE OF THE SECRETARY
WASHINGTON, D. C. 20250

June 28, 1983

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: JOHN R. BLOCK JRB

SUBJECT: U.S. and EC Agricultural Policy Differences

As you are aware, there has been much discussion recently concerning our domestic agricultural policies. In addition, there has been much debate about the European Community Common Agricultural Policy. Some have suggested that both the U.S. and EC farm policies are about the same in direction and approach. This is not true, and attached is a brief paper that outlines the major differences in farm policies.

Attachments

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NOTES ON U.S.-EC AGRICULTURAL POLICY

CM#193 293

	U.S.	EC	Key Difference(s)
1. Policy Goals	Maximize the role of market forces in the operation of the sector while dampening fluctuations in farm income and prices; provide producers with an income safety net and consumers with high-quality, reasonably-priced food supplies.	Management of the market through extensive Community and national government programs designed to enhance farm income; guarantee adequate supplies of high-quality food stuffs albeit at high prices.	Extent to which market forces shape the U.S. sector while Community and national programs shape the EC sector; program costs historically of greater concern in U.S. while food security and farm income of greater concern in the EC.
2. Policy Context	Relatively large farms and fewer farmers...production heavily concentrated in top fifth of producers... politically powerful farm lobbies losing ground as consumer concerns with food quality and prices gain broader support.	Relatively small farms and a large farm population...production less heavily concentrated...politically well organized farm lobbies... agriculture at the center of the EC integration effort.	Powerful EC farm lobbies win the extensive programs necessary to generate high prices and incomes for small farmers despite falling world prices for most commodities; budget pressures and basic policy stance limit the extent of U.S. intervention to stabilizing rather than enhancing farm returns.
	The Administration determines annual program parameters program within the confines of basic legislation; major farm legislation renewed every four years; major modifications made annually since 1977 on both Congressional and Executive initiatives.	Program parameters set annually by unanimous agreement of the agricultural ministers of member states; major policy changes require unanimous "treaty" agreement of member parliaments.	Farm policy more intractable in the EC; institutional setting tends to result in pro-farm policy bias; U.S. policy more flexible with greater non-farm input into policy.

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	U.S.	EC	Key Difference(s)
3. Key Farm Policy Parameters			
a. Policy Mechanisms	With major exceptions (dairy, sugar, tobacco, and peanuts), government intervention in the market through production restrictions, minimum prices generally set below open market prices, and stock adjustments.	Generalized market intervention through annual setting of commodity prices and protection of high Community prices through import levies and export subsidies.	US adjustments to changes in supply and demand occur through production, stock, prices and incomes. EC adjustment occurs through trade using import levies and export subsidies that leave prices and incomes unaffected.
b. Farm Income Determination	Minimum prices for most commodities provide a farm income safety net but leave farmers subject to wide income fluctuations.	Guaranteed high crop and livestock prices ensure high farm incomes with little variability.	High and stable EC farm incomes vs. widely fluctuating U.S. farm incomes.
	Income protection implemented through direct Treasury payments to producers participating in government production adjustment programs: Income protection outside the marketplace.	Income support provided through the marketplace to all producers.	
c. Stock Policy	Large U.S. stocks of farm products account for 25-50 percent of world reserves; stock buildup and drawdowns in response to changes in supply and demand stabilize the domestic and world market.	Significant EC stockholding limited largely to dairy and sugar, products in chronic surplus; stocks of other products generally minimal and unresponsive to changes in market conditions.	U.S.'s stock-holding and stock adjustment process stabilize markets while EC stocking policies do little to stabilize--occasionally destabilize--world markets.

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	U.S.	EC	Key Difference(s)
d. Production controls	U.S. acreage reduction programs for most commodities used to adjust to U.S. and world fluctuations in supply and demand.	Effective EC production controls in place for sugar only.	Steadily rising EC farm output compared with policy-generated adjustments in U.S. output
e. Trade Policy	With some major exceptions, trade flows determined largely by market forces.	Trade "managed" through import levies and export subsidies to achieve farm price, income, and stock objectives.	Dominate role of market forces in U.S. trade; EC use of trade to adjust to changes in internal supply and demand.
-Export Policy	U.S. farm economy dependent on high and rising exports to dispose of domestic surpluses; U.S. products move on the world market with minimal program support largely in the form of aid to developing countries.	Export volume adjusted to dispose of the surpluses generated by high farm prices; export subsidies--averaging 25-30 percent of total export value--used to ensure EC products are priced competively.	Limited U.S. intervention in the export market vs large-scale EC intervention.
-Import Policy	Imports largely determined by market forces; restrictions on beef, sugar, and dairy products.	Imports competing with domestic production subject to high and variable import levies to protect EC farm prices and provide revenue for export subsidy programs; minimal restrictions on other products such as cotton, oilseeds and tobacco.	Relatively open U.S. import policy compared with restrictionist EC policy for major temperate zone products.

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	U.S.	EC	Key Difference(s)
4. Budget			
	Farm program costs borne directly by taxpayers as a line item in the Federal budget	Significant farm program costs borne by EC consumers in the form of $30 billion higher food bill and by foreign trade interests in the form of variable levies on imports; EC taxpayer contributions represent less than half of total program costs.	EC hidden costs not subject to intense political pressure compared with highly visible U.S. costs subject to increasing scrutiny.
	U.S. budget costs average $3-4 billion over 1976/77 - 1980/81; rising support levels and market pressure push budget costs to $21 billion in 1982/83.	EC budget costs average $10-11 billion over 1977-1981; rising subsidy cost of export program pushes 1983 budget costs to $17-18 billion.	Potential budget problems in both the U.S. and the EC.
		Agricultural expenditures will be restricted by EC resource limits by 1984; additional resources require unanimous approval of member governments.	
	U.S. expenditures on commodity programs averaged 2-3 percent of gross agricultural product; in 1983, budget expenditures increase dramatically to 11-12 percent.	EC expenditures on income and price supports are routinely 10 percent of gross agricultural product; 1983 expenditures increase to 13 percent.	

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	U.S.	EC	Key Difference(s)
5. Farm Production, Consumption, and Trade Trends	With U.S. productivity growing at 2-2.5 percent per year and consumption expanding less than 1 percent, the export market will become even more important in the future; 25 percent of U.S. farm output has to be exported to minimize Government cost and keep the sector viable.	With EC productivity growing 2 percent per year and consumption increasing less than 1 percent, export availabilities increasing as fast as in the U.S. Exports subsidized to dispose of surplus production.	EC export subsidies ensure Community surpluses move on the world market--and displace U.S. exports; U.S. faces either a cutback in production or further increases in already large stocks.

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THE WHITE HOUSE

WASHINGTON

June 30, 1983

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: THE WORKING GROUP ON FEDERAL CREDIT POLICY

SUBJECT: FNMA and FHLHC Privatization

The Reagan Administration has consistently indicated that it seeks to make the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) private entities. The 1984 Budget states:

> The Administration also remains committed to seeking the total privatization of two of the housing related Government-sponsored enterprises, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation. Because of their Federal Government sponsorship these enterprises receive special advantages in the securities markets that completely private institutions do not have.

The purpose of this paper is to solicit Cabinet Council guidance on the most appropriate steps to take in pursuing privatization. The first section of the paper provides some background information, the second lists the most important FNMA and FHLMC links to the Federal Government, and the final section presents the Council with three broad options.

The Administration seeks to privatize FNMA and FHLMC because their ties to the Federal Government create a perception by the financial markets that the debt of these enterprises is backed by a "moral obligation" of the Federal Government. This perception gives FNMA and FHLMC the ability to borrow at preferential rates (close to Government rates) and thus absorb more credit than they would if they were strictly private entities.

I. Background

There are a number of factors prompting the development of an Administration position on specific privatization proposals.

- The Senate Banking Committee expects to draft a comprehensive secondary mortgage market bill in July. The bill is intended to: (1) promote the growth of the private sector in the secondary mortgage market; and (2) address the appropriate role and form of FNMA and FHLMC.

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- The Banking Committee action is in large part a response to the Administration's opposition to the proposed FNMA Charter Act amendments, which the Cabinet Council decided to oppose at its April 26 meeting. In testimony before both Banking Committees, Lawrence A. Kudlow indicated that the Administration would be willing to work with FNMA, FHLMC and the Congress to develop a plan that would incrementally make FNMA and FHLMC private entities.

- The 1983 housing recovery and the improvement in FNMA's balance sheet have created an opportunity to discuss specific privatization steps.

II. <u>Links to the Federal Government</u>

The major FNMA and FHLMC links to the Government are:

- FNMA has a Treasury line of $2.25 billion; FHLMC has an indirect Treasury line of $4 billion, through the Federal Home Loan Bank Board.

- FHLMC is exempt from Federal taxes. FHLMC and FNMA both are exempt from State and local income taxes.

- Both FNMA and FHLMC are exempt from SEC registration requirements.

- The common stock interest in FHLMC is wholly owned by the Federal Home Loan Banks (FNMA's common stock is entirely privately held).

- FNMA and FHLMC debt securities are eligible for Federal Reserve Board (FRB) open market purchases and as collateral for advances.

- FNMA and FHLMC securities, by statute and Treasury regulation, are eligible as collateral at face value for deposits of public monies of the United States including Treasury tax and loss (TT&L) accounts. Securities of private corporations are eligible as TT&L collateral at 80 percent of face value.

- FNMA and FHLMC have statutory authority to use the Fed as their fiscal agent, which handles the mechanics of issuing and redeeming debt securities and making interest payments, mostly through the book entry system.

- FNMA and FHLMC debt have equal standing with Treasury debt for unrestricted investment by national banks and State FRB member banks.

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- The President appoints five of the fifteen FNMA Board of Directors and all of the members of the FHLMC Board of Directors (i.e. the three FHLBB members).

- The Federal Government imposes limits on the size of mortgages that the agencies can purchase (statutory) and restricts FNMA debt equity ratio (HUD oversight). Although the agencies don't want these constraints, they could be interpreted as imposing an obligation on the Government should FNMA or FHLMC need assistance.

II. Privatization Options

The key to moving toward FNMA and FHLMC privatization is determining effective steps that can feasibly be taken. The Working Group has considered three different views.

1. Complete privatization including immediately commencing a scheduled phase-out of the Treasury lines of credit.

   This approach would involve recommending immediately commencing with an orderly elimination of the existing governmental links that FNMA and FHLMC now have including a phase out of the Treasury lines of credit.

   The agency status of FNMA and FHLMC is primarily a matter of perception. The most important link in that perception is the Treasury line of credit, (particularly for FNMA; the FHLMC line of credit is indirect). Removing other ties might reduce the attractiveness of FNMA and FHLMC debt and securities, but the perception of a government backing would remain as long as the lines of credit are intact.

   As long as this perception remains, FNMA and FHLMC will continue to borrow at preferential rates. The result: continued Government allocation of credit; and FNMA and FHLMC borrowing advantage over private sector secondary mortgage market participants.

   The lines of credit could be phased out over a number of years. To offer some assurance that the Federal Government will not abandon the secondary market and allow it to collapse, it might be prudent to link privatization with a contingency action, such as permitting GNMA to purchase conventional mortgages with appropriate size limits if the mortgage rate rises above a specified rate.

2. Incrementally removing the existing governmental links that FNMA and FHLMC now have but postponing any action on eliminating the Treasury lines of credit.

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This approach is similar to the first in having as an ultimate objective the complete privatization of FNMA and FHLMC, but involves a more gradual phasing out of the existing links and not raising the prospect of eliminating the Treasury lines of credit at this time.

An orderly scheme for gradually removing FNMA's and FHLMC's ties to the Federal Government could include the following steps, all of which would require legislation:

A. Removing the exemption from SEC registration requirements and regulation of trading. This would require FNMA and FHLMC to develop financial reporting systems that parallel systems required of private corporations. Removal would also require some changes in the relationships among the agencies and the dealer firms that distribute and trade their securities, since many of the firms are not now regulated.

B. Eliminating FHLMC's tax-exempt status. If privatization is linked with trusts for investment in mortgages, TIMs, it might be preferable simply to limit TIMs to taxable entities. (TIMs is described in the second Working Group paper.)

C. Discontinuing the Federal Reserve's fiscal agency relationship with FNMA and FHLMC. Private securities distribution, and redemption and clearing facilities are currently available and are used by private corporations. The sponsored agencies have a significant advantage over private issuers in that their debt securities are on the Fed book entry system, which facilitates trading and use of securities as collateral for various purposes.

D. Removing the preferential treatment of FNMA and FHLMC securities as collateral for deposits of public monies of the United States. This would place the agency securities on an equal footing with securities issued by private corporations.

E. Discontinuing the eligibility of FNMA and FHLMC securities as collateral for Federal Reserve System open market operations.

3. <u>Moving toward a more "level playing field" between the sponsored agencies and private participants</u>.

This approach differs from the first two in that it does not necessarily require or anticipate the complete privatization of both FNMA and FHLMC. It focuses more directly upon facilitating expanded private participation in the market.

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This can be achieved without necessarily requiring the complete privatization of sponsored agencies. At this early stage of development of the secondary mortgage market, it is not certain that there will be no unserved or underserved demand requiring Federal support, analogous to that provided to the primary market by FHA. Unless the Administration is prepared to rely solely upon GNMA and FHA for that support, it should not be assumed that there will not be a need to hold FNMA or FHLMC, or both of them, available to provide it.

At the same time, a principle of this view is that a "level playing field" must be achieved between the sponsored agencies, and between them and private sector entities. TIMs deregulatory changes already accomplished, such as eligibility of "blind pools" for shelf registration, have reduced the spread between private and agency issues. Removal of other agency advantages, such as the differential tax treatment and the SEC exemption, may further narrow the gap. (As an analogy, the President's Commission on Housing recommended management of GNMA fees and FHA premiums for a similar purpose.)

This view also recognizes a fundamental difference between FHLMC and FNMA. The latter already has a wholly private equity interest. Accordingly, imposition of controls on its expansion or profitability is largely infeasible and inappropriate. The same constraints are not applicable to FHLMC. Therefore, FHLMC is a more apt candidate for being retained as the vehicle for Federal secondary mortgage market support mentioned above than FNMA, which is private to a degree that makes it awkward until completely private.

Some steps that would move toward a more "level playing field" with respect to TIMs issues, while also advancing FNMA closer to complete privatization include:

A. Providing FHLMC and FNMA with the authority to issue TIMs, but with a sunset provision ending in 1986.

B. Taxing FHLMC comparable to FNMA, or full taxability of both comparable to private issuers or financial institutions such as thrifts (because of FNMA's portfolio activities).

C. Denying FNMA and FHLMC the SEC exemptions availability to FHLMC or FNMA TIMs, and perhaps sunset of the SEC exemption for other securities, with such grandfathering or other special provisions as may be necessary to assure availability of accelerated registration procedures.

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D. Removing the presidential appointments to the FNMA board and transfering all FNMA debt and capital structure oversight from HUD to the Treasury. (HUD would retain program oversight.)

A majority of the Working Group believes that option two offers a reasonable yet effective first step toward complete privatization of FNMA and FHLMC.

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THE WHITE HOUSE

WASHINGTON

June 30, 1983

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: THE WORKING GROUP ON FEDERAL CREDIT POLICY

SUBJECT: Trusts for Investment in Mortgages (TIMs)

The TIMs concept was first presented to the Cabinet Council on June 15, 1982, following a Presidential decision to oppose the Federal Home Loan Mortgage Corporation (FHLMC) recapitalization proposal because it would not move FHLMC in the direction of a private agency. The Council indicated its support for the TIMs concept, in part because it was a positive complement to the restraint on FHLMC, and asked the Working Group on Federal Credit Policy to develop a complete proposal.

The purpose of this paper is to present the results of the Working Group's further consideration of TIMs. Three options are offered for Cabinet Council review. A decision on TIMs would be timely; the Senate Banking Committee expects to draft a comprehensive secondary mortgage market bill by early July and has expressed considerable interest in TIMs. Moreover, FHLMC's recent bond offering -- collateralized mortgage obligations (CMOs) -- is similar in structure to TIMs in that it contains three different payout rates. The longest term payout is about 25 basis points below FHLMC participation certificates, which are mortgage backed securities with a comparable maturity; the intermediate payout trades about 80 basis points below; and the shortest issue 140 basis points below.

I. TIMs

The TIMs concept was originated by the President's Commission on Housing and recommended as a vehicle to broaden the sources of mortgage credit by removing disadvantages of mortgage-backed securities relative to corporate debt obligations. TIMs is not a single initiative but a series of independent initiatives that would remove barriers to issuing mortgage-backed securities.

The chief advantage of TIMs is that it would possess more flexibility than the current mortgage backed securities in providing a greater measure of call protection to investors. It would: (1) lower the cost of packaging and selling securities by

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appealing to new classes of mortgage investors; and (2) permit financial intermediaries to more efficiently liquidate mortgages from portfolios.

--TIMs is an important complement to the recent deregulation of thrifts. With commercial powers, thrifts are becoming more like mortgage bankers and are moving away from their traditional role as both mortgage issuer and holder. As a consequence, the demand for secondary mortgage market outlets can be expected to grow substantially.

--TIMs is attracting the entry of private sector issuers into the secondary mortgage market. A viable private sector market would restrain the growth of FNMA and FHLMC and the Federal presence in the credit markets. An established private sector might also allay concerns about the transition of FNMA and FHLMC to private sector entities.

Three of the four major elements of TIMs have already been acted on.

1. The Securities and Exchange Commission

Blind Pools: The SEC has changed its requirements to allow mortgage backed securities to be issued as "blind pools", with the prospectus identifying the criteria for mortgage purchases.

Shelf Registration: The SEC has changed its shelf registration procedure to allow a mortgage securities issuer to file a generalized prospectus, which becomes effective upon submission of a supplement providing a generalized description of pool mortgages, with specific loans identified in later reports.

Net Capital Rule: The SEC has reclassified mortgage-backed securities as non-convertible debt, requiring net capital of 10 percent or less instead of the previous 30 percent requirement.

There has been a positive reaction to the SEC's completed actions. Banco Mortgage Corporation (RFC); Merrill Lynch MBS, Inc.; General Electric Morgage Securities Corporation; and Prudential Realty Securities Inc. have filed mortgage security issues under the new rules.

2. The Federal Reserve Board: On January 17, 1983 the Federal Reserve Board: (1) amended its Regulation T to reclassify mortgage-backed securities as "OTC margin bonds" allowing loans against these securities up to the lenders good faith estimate of their value; (2) made substantial changes in its OTC margin bond rules specifically to accommodate the unusual

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characteristics of mortgage securities; and (3) in view of the interest rates risks inherent in assembling a single pool of mortgages large enough to meet the minimum requirement, permitted the issuer of mortgage-backed securites to meet the minimum issue size through a series of issues.

3. Pension Fund Investment: Pension funds represent a major potential source of mortgage credit, yet pension fund investment in mortgage-backed securities is severely hampered by regulations issued under ERISA.

   The Administrator of Pension and Welfare Benefits has agreed that securities meeting the proposed TIM tax definition, having an acceptable investment grade rating and having market yield would also administratively be considered "plan assets."

II. TIMS Action Pending: Taxes

Current tax law requires that an actively managed trust be taxed at both the issuer level and the investor level. To avoid double taxation mortgage backed securities--including those issued by FNMA, FHLMC and GNMA--are issued in the grantor trust form. The issuer cannot provide call protection, and thus improve investor certainty, through the grantor trust. TIMs would permit active management and different payout rates without incurring taxation at both levels.

The inflexibility of the grantor trust is ill suited to mortgages for several reasons:

- Call Protection. Due-on-sale clauses result in prepayment of mortgages when homes are sold. Homeowners may also prepay mortgages as market interest rates decrease. The inability to reinvest or manage cash flows requires that prepayment be passed through to the mortgage-backed security investor, thus denying call protection. Since investors cannot know the duration of their investment, they have no certainty as to maturity or yield. For most investors, this yield uncertainty and reinvestment risk must be accompanied by substantial price concessions.

- Maturity. Since each certificate represents an undivided interest in all mortgages in the pool, each security must have a nominal maturity coincident with the pay-off of the last pool mortgage. This effectively limits mortgage-backed securities to the long-term debt.

- Other. There are severe limitations on discretionary interim investments of funds pending the delivery of loans or periodic disbursements to investors. Thus, "blind pool" securities and other than monthly payment dates are, even if possible, frequently impractical.

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The TIMs proposal is intended to allow the market to solve these problems by vesting a new form of "flow through" entity for mortgage securities and allowing for call protection and multiple classes of securities. The general rules of TIMs would be as follows:

1. The pool could be organized as a trust or corporation;

2. There would be no limits on the number or types of investors;

3. There would be no tax at the pool level;

4. All earnings of the pool would be taxed on a current basis to the investors;

5. The pool would have eighteen months after formation to take delivery of these mortgages;

6. The pool assets could be actively managed, subject to broad restrictions on the sale of pool mortgage assets;

7. The pool could provide call protection through reserves, reinvestment contracts, yield maintenance contracts, collateral substitution agreements, or other arrangements;

8. The pool could not receive active business income (such as fee for service income);

9. The pool could sell two classes of securities, with different rights in cash flows or collateral.

It is not yet clear how the rating agencies will treat TIMs. There has been a reluctance on the part of the agencies to rate mortgages and mortgage backed issues. The recent GECC and Prudential issues were unrated. Without an investment grade rating, it is unlikely that private TIMs issues would be considered "legal investments" for pension funds and insurance companies which are significant purchasers of GNMA, FNMA and FHLMC securities.

One of the features of a TIMs arrangement would be to establish two classes of securities that will provide for call protection in the case of the prepayment of mortgages and offer selected maturities that will appeal to different types of investors. Some investors may demand greater call protection, which would require issuer guarantees and reinvestment obligations. It is not clear how the market would assess the ability of a private TIMs entity to effectively guarantee these features. The ability of FNMA and FHLMC to provide such a guarantee is not questioned in the market, due to the implied Federal backing.

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Federal Revenue Effects

The TIMS proposal as currently structured is estimated to have an insignificant revenue effect. This estimate is based on the latest set of Budget interest rate assumptions. If interest rates were to rise significantly, the tax deferral potential of the TIMs proposal could be realized and the resulting tax shelter activity would result in substantial revenue losses.

III. Options

The Working Group has identified three options for Cabinet Council consideration with respect to TIMs:

Option 1: Delay recommending any tax law changes with regard to TIMs until there is an opportunity to adequately evaluate the three major TIMs initiatives recently put in effect. The Administration would continue its efforts to seek to privatize FNMA and FHLMC.

Advantages:

- If the Administration proposes TIMs tax changes it is likely that any legislation would permit FNMA and FHLMC to utilize TIMs. Under such circumstances private sector efforts could be aborted, because of competitive advantages enjoyed by FNMA and FHLMC.

- The TIMs tax proposal would improve the Federal tax treatment of the housing sector relative to its current status. This raises two objections: (1) the government would be channeling more capital into housing and less into business plant and equipment; and (2) if housing receives tax preferences, even in the nature of eliminating current disadvantages, then other sectors will demand similar treatment. It appears likely that a proposal by FNMA to offer a TIMs-like instrument will be presented shortly; this structure should achieve the advantages of TIMs without the need for a tax change.

Disadvantages

- The TIMs tax proposal is an important recommendation of the President's Commission on Housing and has generated much expectation.

- Not introducing TIMs could place the private sector at a disadvantage if private sector development of TIMs alternatives comparable to the FHLMC CMOs or a similar FNMA security is too costly or inefficient.

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Option 2: Propose TIMs tax legislation that would restrict the use of TIMs to private sector entities.

Advantages:

- TIMs would be targeted to the private sector. However to make targeting effective, changes in the law might be necessary to prevent FNMA and FHLMC from issuing TIMs-like securities, such as the FHLMC CMOs.

Disadvantages:

- There is little doubt that Congress would permit FNMA and FHLMC access to TIMs and that it would be extremely difficult for the Administration to secure legislation restricting TIMs to private sector entities.

Option 3: Propose TIMs tax legislation that would permit FNMA and FHLMC to use the instrument if they gave up some or all of the links to the Federal Government.

Under these circumstances, TIMs might accurately be viewed more as a deregulation than a housing initiative. TIMs would create additional private sector preferences for housing while privatization would take away a governmental housing preference.

Advantages:

- TIMs appears to be one of the major inducements the Administration can offer FNMA and FHLMC to move toward private entities. (Note - the value of TIMs as inducement is inversely related to: (a) FNMA and FHLMC abilities to offer TIMs-like instruments, such as FHLMC's CMOs; and (b) FNMA and FHLMC perception of Congress' commitment to privatization.)

- TIMs with a privatization strategy is consistent with the Administration's principle of relying on the private sector and advances the specific goal of privatizing these agencies.

Disadvantages:

- Due to strong Congressional resistance to privatization, linking TIMs with privatization could kill TIMs.

- If the privatization steps are weak or ineffective, FNMA and FHLMC could become more powerful, and the momentum for privatization could be damaged.

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